United States General Accounting Office

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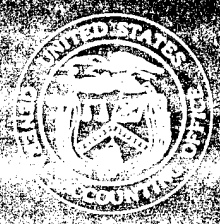
TAX ADMINISTRATION

Approaches for Improving Independent Contractor Compliance



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TAX ADMINISTRATION: Approaches for Improving Independent Contractor Compliance

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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July 23, 1992

The Honorable Max Baucus
United States Senate

The Honorable David Pryor
United States Senate

The Honorable Doug Barnard, Jr.
U.S. House of Representatives

This report responds to your request that we review the tax administrative effects of the Internal Revenue Service's (IRS) Employment Tax Examination Program (ETEP). A major focus of this program is to examine small business compliance using the common law rules (see app. I) for classifying workers as either "employees" or "independent contractors" (self-employed individuals who provide services).[1]

As we found in our 1977 report (see app. II), the common law rules for classifying workers are unclear and subject to conflicting interpretations.[2] Therefore, distinguishing between the two types of workers can be difficult for businesses. IRS can levy large tax assessments against businesses that misclassify workers as independent contractors.

Background

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The rules for classifying a worker as an employee or an independent contractor come from the common law. Under the common law, the degree of control, or right to control, that a business has over a worker governs the classification. If a worker must follow instructions on when, where, and how to do the work, he or she is more likely to be an employee. IRS has adopted 20 common law rules for classifying workers.

Both employees and independent contractors can provide services. Because independent contractors control how they provide services, they are considered to be self-employed individuals. They constitute a diverse cross section of workers, including subcontractors, lawyers, and accountants.

When a business classifies a worker as an employee, the business must withhold income and social security (including Medicare) taxes from the

[1]For this program, IRS has defined a small business as one having assets of $3 million or less.

[2]Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions (GAO/GGD-77-88, Nov. 21, 1977).

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employee's pay and send the taxes to the federal government. The business should report withheld taxes on a wage and tax statement. If a business classifies a worker as an independent contractor, the business need not withhold taxes but must report annual payments of $600 or more to IRS on an information return. IRS then matches information returns and wage statements with tax returns to determine whether workers filed tax returns and reported income. Inadvertent nonfiling of an information return can result in a $50 penalty. (See app. III for more background information.)

As early as 1979, we concluded that noncompliance among self-employed workers, such as independent contractors, was serious enough to warrant some form of tax withholding on payments to them.[3] Since the mid-1970s, IRS studies have documented the lower level of compliance of independent contractors compared to employees. For example, IRS and Treasury officials have testified that employees reported almost all of their income, while an IRS study for tax year 1974 showed that independent contractors voluntarily reported 74 percent of theirs.[4]

Starting in the 1960s, IRS' pursuit of businesses that had potentially misclassified employees as independent contractors and the resulting large tax assessments drew ire from the business community and Congress. The widespread complaints eventually convinced Congress to enact section 530 of the Revenue Act of 1978, which was extended indefinitely in 1982. Section 530 prohibits IRS from challenging a business' treatment of a worker as an independent contractor if the business has a reasonable basis for treating the worker as an independent contractor, files the necessary information returns, and treats similar workers as independent contractors.

Also, in 1982, Congress enacted section 3509 to limit employment tax liabilities for businesses that did not qualify for section 530. Section 3509 limits the liability to 1.5 percent of wages paid to misclassified workers and 20 percent of the worker's share of social security taxes. The percentages double if businesses did not file information returns. In either case, a business pays 100 percent of its share of social security tax.

[3]Hearing on Compliance Problems of Independent Contractors, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, July 17, 1979.

[4]Hearing on H.R.3245, Independent Contractor Tax Status Clarification Act of 1979, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, June 20, 1979.

Therefore, on a 1991 payment of $20,000 to a misclassified worker, the business would owe $2,136 in taxes if an information return was filed but $2,742 if no information return was filed. Section 3509's formulas are set at levels intended to (1) compensate the Treasury for taxes the business failed to withhold from a worker's pay and (2) deter noncompliance.

IRS began the nationwide ETEP in 1988 because of the continually high tax noncompliance of independent contractors. IRS' strategy is to reduce this noncompliance by requiring businesses to treat misclassified independent contractors as employees subject to withholding taxes. Doing so consolidates and facilitates IRS' tax collection so that IRS need not track whether numerous independent contractors paid their taxes. A 1988 IRS study showed that employees subject to withholding voluntarily reported 99.5 percent of their 1987 wages.

The purpose of this report is to (1) follow up on our 1977 report to determine whether the laws and IRS rules for classifying workers are still unclear and (2) determine what approaches in addition to ETEP IRS could use to improve independent contractor compliance.

Results in Brief

The common law rules for classifying workers remain as unclear and subject to conflicting interpretations as we found them in 1977.[5] In the intervening years, no final action has been taken to clarify the common law as our report recommended. The Treasury Department acknowledged in 1982 and again in 1991 that "applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification."[6]

While recognizing this ambiguity, IRS also feels responsible as the nation's tax administrator to enforce tax laws and rules. IRS has enforced the laws and rules in about 6,900 ETEP audits completed from October 1987 through December 1991. These audits resulted in IRS proposing assessments of $468 million and reclassifying 338,000 workers as employees. The average IRS assessment was $68,000. Since fiscal year 1989, IRS data show that 90 percent of ETEP audits found misclassified workers.

[5]Even IRS cannot seem to agree on the interpretation of the rules. A February 1990 IRS study found misclassified workers in IRS and recommended guidance and education as corrective actions.

[6]Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986, Department of the Treasury, Report to Congress (Washington, D.C.: Mar. 1991).

We still believe that the classification rules need to be clarified. However, we also believe that until they are, IRS could use approaches in addition to ETEP to help improve independent contractor compliance. For example, with supporting legislation, IRS could require businesses to (1) withhold taxes from payments to independent contractors and (2) improve business compliance with the requirement to file information returns on payments to independent contractors.

The two approaches, which can be implemented without changes to the classification rules, should help collect more of the taxes owed through means other than retroactive tax assessments provided for in the law. While both approaches would increase to some extent the burdens on independent contractors and businesses that use them, GAO believes both approaches have merit.

Requiring Withholding on Payments to Independent Contractors

The first approach—withholding—is the cornerstone of our tax compliance system for employees. It has worked very well with over 99 percent of wages voluntarily reported. It provides a gradual and systematic method to pay taxes and insures credit for social security coverage.

We continue to believe that a withholding approach has merit, despite several administrative problems that would need to be resolved. The most important consideration in any withholding system is that the tax withheld approximates the tax due for the year. Independent contractors can have substantial business expenses that reduce annual net income and taxes owed. In such cases, withholding could adversely affect cash flow. Because such expenses may vary among independent contractors, a graduated withholding system to account for differences in expenses could be used. A simpler approach for businesses would be withholding a flat amount (e.g., 5 or 10 percent) of all payments.

Another problem is that independent contractors may circumvent withholding by organizing their businesses as corporations, which are exempt from information reporting; to avoid this problem, withholding would also need to apply to corporations. Large corporations may view withholding on payments to them as unjustified since IRS data suggest that their voluntary compliance exceeds that of self-employed workers.

Because of these complexities, designing the most effective and fair withholding system was beyond our review. Nonetheless, we continue to

view withholding as a potential approach for improving independent contractor compliance.

It is likely that any withholding system would exempt some independent contractors. For example, the flat 10 percent withholding proposal by the Treasury Department in 1979 would have exempted workers who (1) normally work for five or more businesses in a calendar year or (2) expect to owe less tax than the withheld amount. Because some workers may be exempt, it would be important to complement any withholding system with an effective information-reporting system.

Improving Information Reporting on Payments to Independent Contractors

The second approach—improving information reporting—parallels the withholding approach in that it would place less emphasis on the classification rules. It would shift the emphasis to the relatively clear laws on information returns.

IRS' data show that independent contractors report 97 percent of the income that appears on information returns filed by businesses. Without these returns, contractors reported 83 percent of the income—a decline of 14 percentage points. Other IRS and GAO studies also show that information returns dramatically improve voluntary compliance.

While other options may exist, we assessed eight for strengthening information reporting and closing potential loopholes. For the most part, we identified the options through our past and ongoing work on information reporting, independent contractors, and other compliance issues. These options follow.

(1) Significantly increase the $50 penalty for failure to file an information return.

An important step toward improving independent contractor compliance is to encourage businesses to file required information returns on payments made to independent contractors. Without the information returns, IRS cannot check through its computer matching program to identify whether independent contractors reported such payments. It is commonly believed that the higher the penalty, the more likely a taxpayer will comply with the tax law to avoid the penalty. Following this logic, we believe that businesses would file more required information returns if they faced a penalty larger than $50 for not reporting an independent contractor payment on a Form 1099-MISC.

The $50 penalty for each unfiled information return does not vary proportionally to the tax revenue lost as a result of the business failing to report the payment on an information return. The penalty is $50, regardless of the amount of the unreported payment. IRS data show that independent contractors voluntarily report more income—and pay more taxes—when businesses report that income on information returns. If a larger penalty induced businesses to file more information returns, it would in turn encourage independent contractors to report more income.[7]

The most recent IRS data show that small corporations in 1987 and sole proprietors in 1988 did not issue information returns on about $3 billion (6 percent) and $5 billion (22 percent), respectively, of payments to independent contractors.[8] This $8 billion, however, does not represent all missing information returns, such as those that larger corporations and partnerships were required to file.

It is also likely that IRS data did not identify all missing information returns. IRS estimated the missing $8 billion by auditing tax returns from small corporations and sole proprietors. In a 1989 report, we stated that IRS' 1988 audits in 7 of its 63 districts did not always identify businesses—including corporations and sole proprietors—that failed to file all information returns on payments to independent contractors.[9] We estimated that 50 percent of these business audits did not identify such unfiled information returns.

IRS officials told us that one reason for the nonfiling and IRS' failure to check for it is the penalty, which is small in comparison with potential tax revenues from other types of noncompliance. For example, during ETEP audits, which address employment taxes, IRS has been assessing an average of about $1,400 for each misclassified worker uncovered.

In addition, the $50 penalty may not be high enough to discourage collusive agreements under which independent contractors accept a lower payment if a business does not report it to IRS. For example, a $50 penalty may not deter a business that can pay $1,000 less for a service by not

[7]An indirect benefit of such reporting would be verifying eligibility for federal entitlement programs. Since 1984, agencies have used IRS' information return data to determine eligibility for programs such as Aid to Families With Dependent Children, and Food Stamps. If information return filing improves, these agencies can better verify eligibility.

[8]IRS defines a small corporation as one with $10 million or less in assets, as opposed to a small business, which IRS defines as any business having assets of $3 million or less.

[9]Tax Administration: Missing Independent Contractors' Information Returns Not Always Detected (GAO/GGD-89-110, Sept. 8, 1989).

reporting a lower payment. IRS would have to audit the business to find the noncompliance. IRS, however, has been auditing less than 3 percent of businesses (corporations and partnerships) and only 50 percent of its audits had checked information return compliance, as we discussed earlier. We believe a higher penalty could deter such agreements.

If the penalty is raised, how much should the amount be? One option is to tie the penalty to some approximation of the taxes lost. IRS data show that independent contractors report 83 instead of 97 percent of payments when information returns are not filed. Depending on the tax rate applied to this unreported income difference, taxes lost could roughly equal 3 percent to 5 percent of a payment. For a $20,000 payment, these percentages would mean a penalty of about $600 to $1,000, respectively.

This option has some disadvantages. Increasing the penalty for independent contractor payments and not for other information returns would be contrary to the conclusion in our report on civil penalty reform.[10] Our report recommended that all information return penalties be the same to ease IRS' administration. In addition, increasing this penalty alone could create potential inequities among businesses; for example, those that fail to file other types of information returns would only have to pay $50. Another potential issue involves assessing a much larger penalty for businesses that simply forgot to file information returns on a small percentage of their payments to independent contractors.

One way to address these issues is to make this penalty proportionate to the tax consequences. The $50 penalty could be retained as a minimum level for inadvertent nonfiling. For higher levels of nonfiling, the penalty could rise as a percentage of the unreported payments so that it would vary with the potential tax revenue. To be consistent and to ease IRS' administration, this approach could apply to all information returns.

(2) Do not penalize businesses for past noncompliance with information reporting laws if they begin to file information returns when the penalty is increased.

Even if the $50 penalty for not filing information returns were increased significantly, many businesses that have never filed information returns may still be reluctant to begin filing if they think doing so will cause IRS to retroactively assess penalties for the previous 3 years. IRS needs some method to bring these recalcitrant businesses into the system.

[10]Tax Policy: Options for Civil Penalty Reform (GAO/GGD-89-81, Sept. 6, 1989).

One way to induce businesses to enter the information reporting system is for IRS to forego assessing the $50 penalty against businesses that had not been filing information returns. For example, if Congress increased the penalty effective July 1993, businesses that began filing could be exempted from the penalty for nonfiling before July 1993.

This option has disadvantages. First, it excuses businesses' past noncompliance with information reporting along with the $50 penalty. Second, businesses may not voluntarily file information returns if they believe penalties will be waived in the future. However, many may not take this risk given a larger penalty and IRS' enhanced ability to detect nonfiling. Further, if businesses begin to file more information returns, the additional revenue from independent contractors voluntarily reporting their income could exceed any revenue lost from IRS not assessing the original $50 penalty.

(3) Require IRS to administer an education program to make the business community aware of the filing requirement and of IRS' intention to vigorously enforce it.

Another way to overcome businesses' reluctance to start filing information returns is for IRS to make businesses aware of their filing requirement and of IRS' intention to enforce it. IRS could increase awareness through an education campaign targeted at the business community and tax return preparers.

IRS officials could not estimate how much such a campaign would cost until IRS decides on the size of the target audience and the media used. The officials said the costs could vary widely depending on these decisions. Further, it is likely that unless Congress were to appropriate these funds, other IRS public education efforts may suffer after absorbing these costs. If some of these eight options were adopted, such as an increased penalty or lowered threshold, we believe that an education program would be crucial.

(4) Lower the $600 reporting threshold for payments to independent contractors.

Lowering the reporting threshold below $600 for payments to independent contractors would better parallel other information reporting thresholds. While some thresholds, such as those for prizes or forgiven debt, would remain at $600, many information returns have lower thresholds. For

example, all payments to fishing boat members and wage earners, among others, should be reported on information returns. Further, information returns should be filed on payments of $10 or more for unemployment compensation, royalties, state and local tax refunds, and certain types of interest and dividends, among other types of income.

Lowering the reporting threshold below $600 should also improve independent contractors' voluntary compliance by having more of their income subject to information reporting. Further, a lower threshold could allow IRS to increase the amount of payments included in its existing computer match for unreported income.

Moreover, a lower threshold could increase the number and amount of payments that IRS can include in the possible computer match (as envisioned in option 6) of the total amount of payments to independent contractors that businesses reported on their tax returns and information returns. This practice should reduce the number of unproductive leads from the match, which create more work for businesses and IRS, and make it more cost-effective for IRS to pursue leads.

For example, a business may be unnecessarily targeted if it reported, on its tax return, making $60,000 in payments to independent contractors of which $44,000 was for payments less than $600 and $16,000 was for those more than $600. IRS' match would make it appear that the business failed to file information returns for $44,000 when the business had fully complied. A threshold below $600 would reduce such instances of unnecessary targeting.

There are disadvantages to this option. Businesses would incur costs from filing more information returns. In addition, an increase in information returns because of a lower threshold would increase IRS' administrative costs and may exceed IRS' capacity to store and match the information. IRS officials said the number of additional information returns that would be filed by reporting payments for less than $600 was not known. As a result, IRS' capacity and costs to process, store, and match more information returns could not be estimated. However, IRS expects its computer capacity to greatly increase by 1996.

(5) Require information reporting for payments to incorporated independent contractors.

The exemption for information reporting on payments to corporations creates a loophole for businesses and independent contractors.[11] Unless this loophole is closed, independent contractors can incorporate to shield income from information reporting. And some businesses could use incorporated independent contractors to avoid the penalty for not filing information returns, particularly if the penalty were raised. Such use would encourage more independent contractors to incorporate and could result in less work for those who remained unincorporated.

Reporting all payments for services, regardless of the status of the recipient, would also eliminate problems in distinguishing between payments to individuals (which are reportable) from those to incorporated contractors (which are generally not reportable).

Conversely, requiring that payments to incorporated independent contractors be reported would increase businesses' costs for filing more returns. As discussed in option 4 (on a lower reporting threshold), IRS would need more computer capacity and have higher costs to process, store, and match the additional information returns. IRS also would have additional costs to pursue more leads from the computer matches for overstated deductions and unreported income.

(6) Require businesses to separately report on their tax returns the total amount of payments to independent contractors.

Requiring businesses to separately report on their tax returns the total amount of payments to independent contractors would parallel the reporting of salaries and wages to employees. We believe it would draw attention to these payments and the need to also report them on information returns.[12] Because businesses are subject to perjury penalties for filing false tax returns, separate reporting could better ensure that the payments are identified and accurately reported. Similarly, tax return

[11]In 1991 testimony before the House Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee on Government Operations, we recommended information reporting on five types of corporate income (IRS Needs To Implement a Corporate Document Matching Program, GAO/T-GGD-91-40, June 10, 1991). This option builds upon that work by requiring that payments made to corporations for services be reported.

[12]Businesses could report payments in one of two ways—on a deduction or an information line—on income tax returns. A deduction line would be comparable to the wages line but for services from independent contractors. Businesses would have to separate the portion of deductions on other lines of the return that are for services. For example, a $5,000 invoice for advertising may include $3,500 for services and $1,500 for ads. The $3,500 would be reported on the deduction line and $1,500 would be reported on the advertising line. Under the information option, the business would still report the $5,000 on the advertising line but also report $3,500 on the information line.

preparers should give more attention to the accurate reporting of separately listed expenses.

With this option, IRS could enhance its ability to detect noncompliance in filing information returns. IRS could computer match the total amount of payments to independent contractors that a business reported on its tax return with amounts reported on information returns. Any discrepancy above a minimum amount could trigger an inquiry from IRS. For example, if a business' tax return reported a total of $60,000 in payments to independent contractors and the computer match shows that the same business reported only $44,000 in such payments on information returns, IRS could ask the business to explain this discrepancy.

This option would not stop all businesses from hiding payments to independent contractors, but we believe it should deter many. It also may increase businesses' costs in two ways. If tax preparers do more checking on the reporting of payments, businesses may incur more costs. In addition, some businesses' costs would rise if they have to modify their accounting systems to report payments on a separate tax return line.

IRS officials said IRS' costs to change the tax return are nominal since IRS regularly makes changes for other reasons. Developing a new computer match also would involve some costs, but IRS officials said the major costs would be entering the data into the computer.

(7) Require businesses to validate the tax identification numbers (TIN) of independent contractors before making any payments and for those with invalid TINs, withhold 20 percent of payments until the TINs are validated.

Another way to increase independent contractor compliance is to expedite the process for identifying workers who provide invalid TINs. IRS receives most information returns in January and February and has taken more than 1 year to notify businesses that an information return had an invalid TIN. For example, IRS issued most of these notices for tax year 1990 information returns in March 1992.

As a result, independent contractors can submit incorrect TINs to businesses and receive all their pay before IRS can notify the business that a TIN on the information return was invalid. When this occurs, it may be too late for the business to begin withholding 20 percent of the worker's pay as required by section 3406 (referred to as backup withholding). It also

may be too late for the business to obtain the correct TIN so that IRS can use the information return to check for unreported income.

For 1990, about 4.4 million (7 percent) of the 61.7 million Forms 1099-MISC sent to IRS could not be used in a computer match because TINS were missing, incomplete, or otherwise inaccurate. In March 1992, IRS sent 488,000 backup withholding notices on payments to individuals whose TINS were invalid.

IRS could require businesses to validate workers' TINS before paying them. This validation could be done by telephone, using technology similar to that used to validate credit card purchases. If independent contractors provided invalid TINS, businesses could start backup withholding with the first payment rather than waiting more than 1 year. They could continue withholding 20 percent of the payments until the TINS were validated.

According to IRS' Office of Chief Counsel, informing a business that a TIN is invalid would not constitute a disclosure of taxpayer information (particularly if validation is tied to the backup withholding authority). IRS officials said IRS concluded in January 1992 that allowing businesses to validate TINS had merit and approved a test project at IRS' Martinsburg Computing Center. They said the test should be done by December 1992.

This option would impose new costs on all businesses that use independent contractors. Each business would have costs to validate the TINS. Now, only businesses that receive backup withholding notices must incur costs. However, up-front TIN validation should lead to fewer after-the-fact notices, which could lower businesses' costs; if independent contractors continue to provide invalid TINS, backup withholding would become more cost-effective. Further, IRS could reduce business costs by providing toll-free 800-telephone numbers to validate TINS. As for other costs, IRS officials said IRS' major cost would be about $236,000 to buy the equipment to validate TINS.

(8) Require businesses to provide independent contractors with a written explanation of their tax obligations and rights.

Another option that may help independent contractors to voluntarily comply is to inform them of their tax obligations and rights as self-employed workers. Businesses are not required to notify them of the effects of being classified as independent contractors rather than as employees. If these workers knew their rights, they might choose to work

elsewhere as employees or complain to IRS about being classified as independent contractors. If they knew their tax obligations as independent contractors, these workers might be more likely to set aside enough funds to pay their taxes.

Various congressional reports and hearings indicate that independent contractors lack sufficient information on their rights and responsibilities. For example, the House Committee on Government Operations issued a 1990 report that recommended that IRS require businesses to advise their independent contractors of the tax obligations associated with self-employment.[13] This report referred to a February 1986 hearing that uncovered evidence that home-based clerical workers did not always know about their tax obligations as independent contractors.[14]

More recent congressional hearings suggest that many independent contractors are not informed of their ineligibility for fringe benefits available to employees (e.g., health and retirement plans).[15] Similarly, House Subcommittee Chairmen raised related issues in an October 16, 1991, letter to the Chairman, House Ways and Means Committee:

"Many (workers) are also unaware of the fact that they will not receive benefits and do not qualify for unemployment compensation. As a result, the worker may not set aside enough funds to pay self-employment taxes, and purchase needed benefits such as health and disability insurance."

The notification of tax obligations and rights could be done on an IRS form that the business provides. In addition to clarifying the obligation to pay taxes, the form should state that (1) the business must file required information returns on payments made to independent contractors, (2) any worker can ask IRS to review the business' classification of its workers, and (3) independent contractors are ineligible for the business' fringe benefit plans but can establish such plans for pension, accident, and health insurance. The business and independent contractor should sign the form to certify that it has been provided, and each should retain a copy of the form in case IRS requests it.

[13]Tax Administration Problems Involving Independent Contractors, House Committee on Government Operations (Washington, D.C.: Nov. 9, 1990).

[14]Hearing on Home-Based Clerical Work, Subcommittee on Employment and Housing, House Committee on Government Operations, February 26, 1986.

[15]Hearing on the Misclassification of Workers as Independent Contractors, Subcommittee on Employment and Housing, House Committee on Government Operations, April 23, 1991.

This option would place a short-term burden on businesses to complete forms for existing independent contractors. However, these completed forms would not expire. Thus, new forms would only be needed for new independent contractors, so that this practice should not be unduly burdensome in the long term. An IRS official said the costs to develop the form would be nominal.

Other Options

As we completed the work for this report, H.R. 5011—the Employment Tax Improvement Act of 1992—was introduced to revise employment tax procedures and to increase information reporting along with the compliance of independent contractors. This proposed legislation has provisions on options that we did not analyze.

For example, H.R. 5011 proposes replacing the large retroactive assessments we discussed earlier with a penalty, of up to $500, for misclassifying a worker—if the business filed required information returns on that worker. The bill also proposes eliminating the ban on IRS guidance and incorporating a revised section 530 (which provides employment tax criteria for classifying workers) into the tax code. We have not done enough work to take specific positions on these provisions; we can, however, offer the following observations.

Replacing the retroactive assessment with a lower penalty when businesses filed information returns would ease their financial burdens, particularly those who inadvertently misclassified workers under the unclear classification rules. These businesses no longer would face these large assessments for up to 3 years. Businesses that made a good-faith effort in interpreting the unclear rules and by filing the information returns may find this less onerous. Businesses that fail to file these returns would not qualify for the lower penalty.

On the other hand, businesses may choose to misclassify more workers, particularly given technological advances that reduce the need to have employees at the workplace. These businesses may be willing to file all information returns and pay the lower penalty if they can avoid paying thousands of dollars in fringe benefits and social security tax. If these workers, in turn, do not pay their self-employment taxes and buy needed coverage for periods such as illness and retirement, the federal government may have to provide them with a social safety net. If so, other taxpayers could face a larger tax burden. Further, if businesses abuse this provision by misclassifying workers, competitors that properly classify

their workers as employees may suffer a financial disadvantage. Using employees tends to raise operating costs to pay for fringe benefits and additional taxes.

Lifting the ban on IRS guidance could provide more certainty to businesses in classifying workers. Incorporating a revised section 530 into the tax code should reduce the number of cases in which workers are treated as independent contractors for employment taxes but as employees for income taxes and pension plans. Doing so could generate more social security taxes because neither the business nor the worker now pays the business' share under section 530. However, to achieve the maximum positive effect from lifting the ban, the guidance provided to help businesses classify workers must be clear and certain. For example, to the extent that criteria—such as "industry practice"—remain unclear, incorporating the revised section 530 into the tax code will do little to reduce the controversies between IRS and businesses over misclassification.

Conclusions

The common law rules for determining who is an employee or independent contractor remain as unclear today as 15 years ago. Efforts to clarify the rules have been unsuccessful. Yet taxpayers still need—and government is obligated to provide—clear rules for classifying workers if businesses are to voluntarily comply. We recognize that this clarification will not happen in the short term, given that past efforts did not succeed. However, we favor clarification and believe that Congress should continue its efforts to develop clearer rules.

In view of the dilemma over classification rules, during the late 1970s, Congress considered withholding as a way to improve independent contractor compliance. Withholding was not implemented due to concerns about doing it fairly. Because withholding has been a successful tool for collecting taxes from employees, it deserves more consideration as a tool for improving the low tax compliance of independent contractors.

Strengthening information reporting could also improve independent contractor compliance. But each option for improving information reporting has implementation costs and potential burdens. And none of the options replaces the need to clarify the unclear classification rules. In fact, these options, or others not discussed in this report, would work better in conjunction with clearer rules, if they emerged.

IRS' estimate of the 1992 tax gap caused by self-employed individuals (including independent contractors) who do not report all their income is $20.3 billion.[16] Finding a way to reduce this tax gap at an acceptable level of added costs and burdens is important to tax administration. It may be even more important in the future as technology leads to an ever wider variety of working arrangements. Thus, we believe that any legislative deliberations should focus on the various ways to improve compliance—weighing their advantages and disadvantages—and consider input from the affected parties.

Matters for Congressional Consideration

We continue to believe Congress needs to establish clear rules for classifying workers as we recommended in our 1977 report. We also believe that Congress should consider legislation to improve independent contractor compliance through withholding and/or improved information reporting.

Objectives, Scope, and Methodology

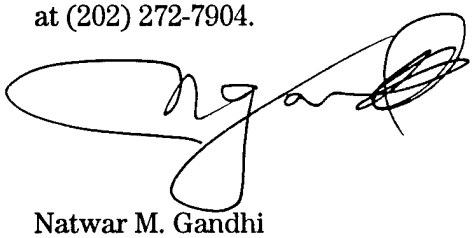
To follow up on our 1977 report, we reviewed current laws and IRS' 20 rules for classifying workers and various other GAO, Treasury, and IRS reports on classification.

To determine what approaches other than ETEP that IRS could use to improve independent contractor compliance, we reviewed various IRS data on ETEP results, and various studies and congressional hearings on worker classification. We also interviewed various officials from IRS and Treasury as well as private groups, including the American Bar Association, National Federation of Independent Business, Small Business Legislative Council, the American Institute of Certified Public Accountants, and the Tax Executives Institute.

We did not obtain written comments from IRS on this report. We did, however, provide a draft of the report to responsible IRS officials. They generally agreed with the facts presented, and we incorporated their comments where appropriate. We did our work in Washington, D.C., from August 1991 to May 1992 in accordance with generally accepted government auditing standards.

[16]IRS defines the tax gap as the difference between the amounts of income tax that taxpayers owed and voluntarily paid for 1 year.

We are sending copies of this report to the Secretary of the Treasury, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget, and other interested parties. We will make copies available to others upon request. Major contributors to this report are listed in appendix V. If you have any questions on this report, call me at (202) 272-7904.



Natwar M. Gandhi
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Administration Issues

Contents

Abbreviations

ETEP	Employment Tax Examination Program
IRS	Internal Revenue Service
TIN	taxpayer identification number

IRS Rules to Classify Workers

With the exception of certain jobs, the criteria for determining whether a worker should be classified as an employee or an independent contractor are based on common law rules. Under the common law, the major factor determining the classification of a worker is the degree of control, or right to control, that a business has over the worker. For example, if the worker is required to comply with instructions about when, where, and how the work is to be done, he or she would be classified as an employee.

IRS has summarized the common law in 20 rules that must each be weighed in light of the facts to determine whether workers are employees or independent contractors. The weight afforded to each of these 20 rules to classify workers can vary with each case. However, workers generally are employees when they:

(1) Must comply with employer's instructions about the work.
(2) Receive training from or at the direction of the employer.
(3) Provide services that are integral to the employer's business.
(4) Provide services that must be rendered personally.
(5) Hire, supervise, and pay workers for the employer.
(6) Have an ongoing working relationship with the employer.
(7) Must follow set hours of work.
(8) Work full-time for an employer.
(9) Do their work on the employer's premises.
(10) Must do their work in a sequence set by the employer.
(11) Must submit regular reports to the employer.
(12) Receive payments of regular amounts at set intervals.
(13) Receive payments for business and/or travelling expenses.
(14) Rely on the employer to provide tools and materials.
(15) Lack a major investment in resources for providing services.
(16) Cannot make a profit or suffer a loss from their services.
(17) Work for one employer at a time.
(18) Do not offer their services to the general public.
(19) Can be fired by the employer.
(20) May quit work at any time without incurring a liability.

GAO's 1977 Proposal to Clarify the Laws on Worker Classification

In 1977, we issued a report entitled Tax Treatment of Employees And Self-Employed Persons by the Internal Revenue Service: Problems and Solutions (GAO/GGD-77-88, Nov. 1977). This report explored independent contractor issues. Among other things, we said the 20 common law rules were confusing and inconsistently applied. To lessen the confusion and the controversy caused by IRS enforcement, we recommended that Congress amend the law to exclude from the common law definition of "employee" those workers that:

- had a separate set of books and records for their business,
- could suffer a loss or make a profit,
- had a principal place of business other than the employer's, and
- made their services generally available to the public as self-employed individuals.

Under this test, a worker was an independent contractor when all four conditions were met. If three were met, the common law rules applied. Otherwise, the worker was an employee.

Since 1977, Congress has not clarified the classification rules. Instead, Congress enacted section 530 in 1978, which limited IRS' authority to reclassify workers as employees, among other things. Under section 530, IRS could not assess employment taxes for misclassified workers if the business had a reasonable basis for its classifications, such as a reliance on (1) a judicial or administrative precedent or technical advice and letter rulings to the taxpayer, (2) a prior IRS audit that did not challenge the classification scheme, (3) an industry practice, or (4) any other reasonable basis. To qualify for this protection, the business must have filed all required information returns and have treated similar workers uniformly. Congress enacted section 530 on a temporary basis but extended it indefinitely in 1982.

In 1989, we reported that IRS could not assess $7 million of $17 million in recommended taxes and penalties against employers who misclassified employees as independent contractors for 1986 and 1987.[1] In the cases we studied, employers usually escaped the assessments by claiming the prior audit protection. We found that this protection existed even when the prior audit did not intend to address classification or when it occurred over 20 years earlier. For these and other reasons, we recommended that Congress consider authorizing IRS to require employers with section 530

[1]Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 25, 1989).

protection to prospectively reclassify independent contractors as employees.

Without any further legislative clarification, the application of the common law rules continues to vary in different situations and often remains a subjective matter. The Treasury Department acknowledged in 1982 testimony that "applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification."[2] This finding was repeated in the Treasury Department's March 1991 report to Congress on technical service workers.[3]

Congressional testimony has shown that IRS' interpretation of the common law can lead to inconsistent and inequitable treatment of businesses. A November 1990 House Committee on Government Operations report cited an example.[4] IRS examined classification decisions of two Florida drywall companies with similar operations. IRS concluded that one company had to reclassify workers while the other company did not. At least one worker did the same type of work for each business. The business owners concluded that the inconsistent IRS rulings resulted from having different IRS examiners audit their businesses and apply the common law rules differently.

Without clear classification rules, businesses cannot, with any degree of certainty, determine who IRS will consider an employee until after an audit. As a result, businesses may be assessed additional employment taxes for misclassifying workers even if they acted in good faith in interpreting unclear laws and in filing all information returns on those they classified as independent contractors.

[2]Statement of the Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, before the Subcommittee on Oversight, Senate Committee on Finance, April 26, 1982.

[3]Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986, Department of the Treasury, Report to Congress (Washington, D.C.: Mar. 1991).

[4]Tax Administration Problems Involving Independent Contractors, House Committee on Government Operations (Washington, D.C.: Nov. 9, 1990).

Issues Affecting the Classification Decision

Businesses need to make accurate classification decisions because many laws apply only to employees or independent contractors. Some examples of how these laws can be applied follow.

A business may provide fringe benefits, such as pension and health plans, on a tax-free basis to employees but not to independent contractors. If a business misclassified employees as independent contractors, its benefit plans may lose their tax-favored status. Other laws permit self-employed workers but not employees to set up tax-qualified benefit plans.

If workers are determined to be employees, the business must withhold income and social security (including Medicare) taxes from employees' wages. The business must also contribute to the social security fund at the same rate as employees and pay an unemployment insurance tax. If the business offers fringe benefits, employees must be allowed to participate under tax-qualified plans pursuant to nondiscrimination and minimum coverage laws.

If workers are determined to be independent contractors, they must pay income and social security taxes on payments received from the business. However, independent contractors have fewer restrictions on their ability to deduct business expenses than employees. Employees generally may not deduct their business expenses unless they itemize deductions on their tax returns and then only to the extent that expenses exceed 2 percent of their adjusted gross income from all sources.

Although businesses do not have to withhold and pay taxes on payments to independent contractors, they must file information returns to report payments for services of $600 or more. A business that fails to file an information return can be penalized $50 by IRS. Payments to independent contractors who have incorporated do not have to be reported to IRS.

IRS computers match these information returns with the worker's tax returns to determine whether the worker reported the payment. This matching process provides IRS with a systematic method for identifying potentially unreported income. IRS also can detect unreported income through audits. But audit coverage has declined. In 1991, IRS audited 2.14 percent of self-employed workers, less than the 3.35 percent audit coverage for 1981.

Unreported income contributes to most of the income tax gap. Of the $62.8 billion income tax gap from individuals not reporting income in 1992, IRS

estimated that self-employed workers account for $20.3 billion, or 32 percent. IRS officials did not know the exact portion of the $20.3 billion that is attributable to independent contractors but believed that they accounted for much of this tax gap.

Further, the estimated 1992 tax gap for misclassified workers will be $2.1 billion, based on an IRS study.[1] In this study, IRS estimated that about 750,000 businesses (15 percent) of the 5.2 million filing employment tax returns in 1984 had misclassified 3.4 million workers.

When IRS determines that employees have been misclassified as independent contractors, section 3509 of the Internal Revenue Code reduces the employment tax liability that would otherwise be assessed against a business. Section 3509 contains two formulas for assessing the tax, depending on whether the business filed an information return on the payment to the misclassified worker. The formula is 1.5 percent of wages paid and 20 percent of the social security taxes that should have been withheld on the misclassified employee's pay. These percentages double if no information return was filed. In both cases, the business must pay 100 percent of its share of social security taxes.

[1]Using IRS' study data, we adjusted IRS' misclassification tax gap estimate for 1984 to 1992.

GAO's Analysis of Options for Improving Information Reporting

We assessed eight options for improving information reporting, which could improve tax compliance among independent contractors. The pros and cons for each option are shown in table IV.1.

Table IV.1: Pros and Cons of Eight Options for Improving Information Reporting to Enhance Independent Contractor Compliance

Options	Pros	Cons
(1) Increase $50 penalty for failure to file an information return (Form 1099-MISC).	Should improve compliance in filing Form 1099-MISC. Should increase income reported and taxes paid by independent contractors. Would encourage IRS to check Form 1099-MISC filing during audits. Would discourage businesses from agreeing to not file Form 1099-MISC if they can make lower payments.	Would complicate IRS administration if other penalties for failure to file Form 1099-MISC are $50. Would cause equity concerns if one penalty was higher than others.
(2) Do not penalize businesses for past Form 1099-MISC noncompliance if they begin filing.	Would encourage filing compliance. Would ease the transition to a higher penalty for not filing Form 1099-MISC.	Would not punish past noncompliance. Would result in lost penalty revenue. May raise expectations of future penalty forgiveness.
(3) Have IRS educate businesses on Form 1099-MISC filing requirements and penalties.	Should increase business compliance with filing Form 1099-MISC.	Would add to IRS' costs or use funds that could be used for other educational purposes.
(4) Lower the $600 reporting threshold for payments made to independent contractors.	Would include more payments in IRS' computer match to detect unfiled information returns and unreported income. Should improve independent contractor compliance. Would mirror other lower thresholds (e.g., $10 royalties).	Would increase costs to businesses to file more information returns. Would increase costs to IRS to process and match more information returns. May exceed IRS' computer capacity until 1996.
(5) Require businesses to report payments made to incorporated independent contractors.	Would deter attempts to avoid information reporting. Businesses would not need to distinguish between incorporated and unincorporated workers.	Would increase costs to businesses to file more Forms 1099-MISC. Would increase costs to IRS to process and match more Forms 1099-MISC. May exceed IRS computer capacity until 1996.

(continued)

Options	Pros	Cons
(6) Require businesses to separately report on their tax return the total amount of payments to independent contractors. IRS would match amounts reported on tax return and on information returns.	Should increase Form 1099-MISC compliance. Could enhance IRS' ability to detect noncompliance. Give tax return preparers more incentive to check compliance.	Will not stop some businesses from hiding payments to independent contractors. May increase some businesses' costs to report the information.
(7) Have businesses validate Taxpayer Identification Numbers (TIN) before making payments. If TIN is invalid, a business must withhold taxes beginning with first payment and continue withholding until a TIN is validated.	Should improve IRS matching and increase taxes collected. Should make backup withholding more cost-effective by reducing it or starting it with first payment to independent contractors.	Would add burden for businesses to validate TINs before paying contractors. Would increase IRS' equipment costs.
(8) Have businesses notify independent contractors of their rights and obligations to pay taxes as self- employed workers.	May improve voluntary tax compliance. Would encourage workers who believe they are misclassified to notify IRS. Would inform workers of their rights and obligations.	Would add burden on business to provide the Form 1099-MISC to the worker and retain a copy.

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